

## Us vs Hedge funds and Professional Traders

Okay we know that trading is competitive. If everyone targets the same market inefficiency, that market inefficiency is eroded

(Eg. If everyone shorts Mastercard and longs Visa, the 2 stocks will eventually converge and the pair trading opportunity is gone)

Our competition, the hedge funds and big trading firms, have billions in capital, teams of experienced and highly qualified portfolio managers, traders and analysts, cutting edge hardware and software infrastructure and real-time access to material market information.

We have a rusty old laptop, a free trading software, questionable Wi-Fi (and hopefully free power sockets at our corner cafe).

What chance do we have?

## Retail vs Institutions

Fortunately, the answer is... some.

The good news is institutional traders and retail traders have different edges in the market. Retail traders can succeed if they know how to play their game right. To understand the difference between us and them, let's look at the advantages and disadvantages retail traders have compared to the big boys.

### Advantages

#### 1. Small Capacity

Hedge funds have large capital base and this limits the markets they can access. As retail traders, we can fly under the radar and tackle markets that doesn't have enough liquidity to absorb the big boys. This is our biggest strength.

#### 2. Exotic and Unregulated Markets

Big funds are regulated by government agencies. They can only put their capital in certain approved markets. We can trade any products. Cryptocurrencies? Go for it. Stock market in developing countries? Go for it. Unregulated derivatives? Go for it.

#### 3. No Pressure to Trade

Strategies come and go. The average lifespan of a strategy is about 1 to 3 years. What should we do when our strategy dies? We research and develop new ideas (note: you should be developing new ideas even when you have a working strategy). Don't try to force a trade when there is none.

Funds have pressure to deploy their capital. They might get in trouble with their investors if they don't use their cash. Thus, they might be forced to make subpar trades. Unlike us, they don't have the luxury to sit and wait for the perfect opportunity to pounce.

#### 4. Lack of Investment Mandate

Some hedge funds and most asset management firms have investment mandates they have to follow. A Long-only APAC Equity Fund has to absorb the beta risk of Asian equities (unless they hold 100% cash which is unlikely) even if they are bearish on Asian Equities. Retail traders on the other hand can adapt their play to the varying market conditions.

## 5. Low Execution Risk

Imagine if an asset management fund wants to buy a significant stake into Company Banana. This will definitely move the market. Other players may notice and join the trade. This pushes the price higher and raises the fund's entry price.

Retail traders rarely move the market. Rarely do people care what they do – maybe except for this guy: <http://www.bloomberg.com/news/2014-09-25/mystery-man-moving-japan-made-more-than-1-million-trades.html>

## 6. Funds Experience Capital Withdrawals

Capital withdrawals tend to be disruptive to the investment strategy. Withdrawals may cause the fund manager to liquidate his holdings to raise cash. This is especially disruptive if the asset liquidated is illiquid since cost of liquidation is high (executing at bad prices and paying up bid-ask spreads etc).

## 7. Disclosure

Large funds that are regulated have to disclose some information on their holdings. This makes it more difficult for them to outmaneuver the market.

## Disadvantages

### 1. Lower Fees and Spreads

Big funds have better bargaining power and can negotiate lower execution cost. Retail traders pay high commission and spreads. In most cases, retail traders are taking prices as opposed to making prices (unless they trade using depth-of-market/2nd level systems). As a price taker, retail traders pay higher spreads.

### 2. Best Services and Wide Range of Products

Big funds have access to prime brokerage, other support services and a wide range of financial products. These support services spend countless hours researching and executing the best deals for the funds. Retail traders do not have this luxury.

### 3. Fast Information

Information is king. Funds have access to important information quicker than the general public. This gives them an edge.

### 4. Top Technology

Big funds invest top dollar into better infrastructure. These infrastructure aids their trading in terms of research/backtesting, execution and risk management. This allows them to engage in complex trades that the retail traders cannot access.

### 5. Leverage

Funds have better credit rating than the average retail trader. Hence, they are able to get better leverage and terms. This allows them to weather tough times and increase returns with a smaller base capital.

## Moving Forward

Once we understand the different circumstances between the big boys and us, we should realise that the real question here is not "How do we outwit the big funds?". It is "How do we find market inefficiencies that are untouched by the funds".

Google will not touch a \$20,000 per month revenue opportunity – it is too small. However, this is big enough for a one-man tech company.

Similarly, Bridgewater (a big hedge fund) will not touch a penny stock that has \$300,000 daily trading volume<sup>1</sup> (and no that's not a lot). Making \$1,000 a day is not worth their time. But you and I probably won't mind an extra \$1,000 a day.

We should look for new and/or exotic markets, for unregulated markets, for new ways to evaluate opportunities that aren't done or taught before. Creativity is your biggest weapon.

We don't have to beat them to be successful. Keep targeting these pockets of alpha<sup>2</sup> in the market, until we grow big enough to play in the same playground as the big boys.

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<sup>1</sup> <https://www.investopedia.com/terms/v/volumeoftrade.asp>

<sup>2</sup> <https://www.investopedia.com/terms/a/alpha.asp>